Internal Controls:

Naval Audit Service's Philosophy and Perspective on Material Weaknesses

ASMC Conference

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June 1, 2011

Agenda

- Background
- What Are Internal Controls?
- Auditor's Role
- Why Controls Are Important
- 2010 DON Material Weaknesses
- Questions

NAVAUDSVC Philosophy on Critical Internal Controls

- Control Environment
  - Tone at the Top
- Policies and Procedures
  - Assure continuity of operations
- Vulnerabilities/Weaknesses
  - Identify and correct
- Monitor
  - What is measured gets done

BACKGROUND

Naval Audit Service Mission

We provide independent and objective

audit services to assist Naval Leadership

in assessing risk to improve efficiency,

accountability and program effectiveness

Legislative Acts

- Accounting & Auditing Act of 1950 – Gave Federal Agency Heads responsibility for establishing and maintaining adequate system of accounting and internal controls
- Federal Managers' Financial Integrity Act of 1982 – Amended 1950 Act and provided for:
  - Development of guidelines by OMB and GAO
  - Evaluation of internal controls IAW guidelines
  - Reports on compliance with GAO & OMB standards & guidelines
  - Identification of material internal controls weaknesses and plans to correct them
- OMB Circular A-123 "Internal Control Systems" & Circular A-127 "Financial Management Systems"

WHAT ARE INTERNAL CONTROLS?

Internal Controls vs. Management Controls

Internal Controls = Management Controls

Management Controls = Internal Controls

“INTERNAL CONTROLS” is the preferred term

What are Internal Controls?

- Internal Controls are all methods which an organization governs its activities to accomplish its defined objectives. They are processes designed to provide reasonable assurance that:
  - Programs achieve intended results
  - Operations are effective and efficient
  - Financial reporting & information is reliable
  - Laws and instructions are followed
  - Assets are safeguarded

Everyday Internal Controls

- School emails
- Homework logs
- Keyless entry on car doors
- Parental Controls on television and the Internet
- Internal seals on food and medicine
- Clothing control tags (ink or electronic)
- House keys can’t copy
- Changing passwords
- Charge card receipts
- Child-proof medicine bottles
- Home security systems
- Airplane boarding pass

Typical On-the-Job Internal Controls

- Cipher door locks
- Separation of Duties
- Supervisory reviews, authorizations, and approvals
- Monthly reconciliations
- Monthly error reports
- Annual personnel ratings
- Common Access Cards
- Changing passwords
- Performance metrics
- Quality assurance reviews
- Contract provisions
- Contractor surveillance plans

Five Interrelated Standards of Internal Controls

- Control Environment
- Risk Assessment
- Control Activities
- Information & Communication
- Monitoring

Control Environment

- Sets the tone of an organization
- Influences control consciousness of the people
- Sets the foundation for the other 4 standards
- Provides discipline/structure

How integrity, ethical values, competence, management philosophy, operating style, development of people, assignment of authority, accountability, mission statements, strategic plans, and training

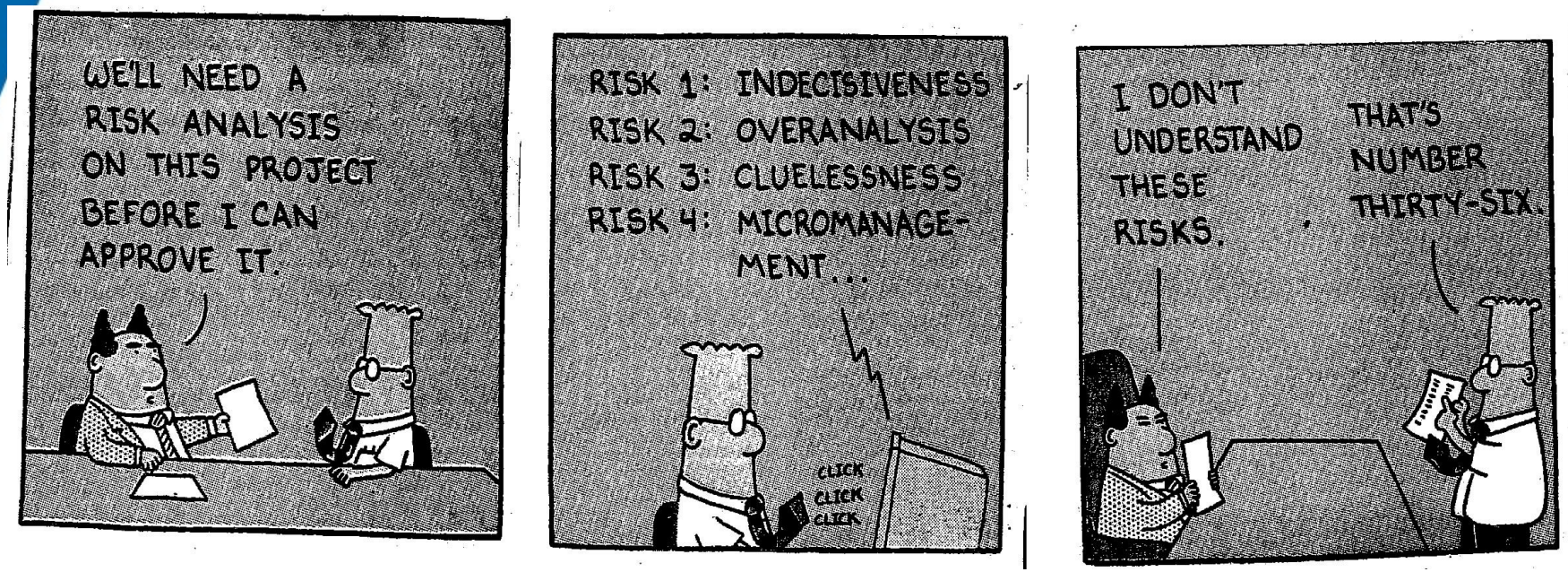
Risk Assessment

- Risk is never managed – organizations are managed in anticipation of uncertainties presented by risk
- The organization's identification/analysis of relevant internal and external risks to achieving objectives – a pre-requisite to assessing risk is establishing objectives
- Objectives identify risks analyze potential risks manage organization to mitigate risk

How = management conferences, consideration of audit findings, forecasting, and what if discussions

Risk Assessment

Risk Assessment


WE'LL NEED A RISK ANALYSIS ON THIS PROJECT BEFORE I CAN APPROVE IT.
RISK 1: INDECISIVENESS
RISK 2: OVERANALYSIS
RISK 3: CLUELESSNESS
RISK 4: MICROMANAGE-MENT...
CLICK CLICK CLICK
I DON'T UNDERSTAND THESE RISKS.
THAT'S NUMBER THIRTY-SIX.

Control Activities

- Policies, procedures, and instructions that provide management's directions are followed
- Address the risk associated with achievement of objectives
- At every organizational level and function

How = Approvals, authorizations, verifications, reconciliations, operating reviews, security of assets, segregation of duties, documentation, timely recording & reporting, physical controls, and access restrictions

Information & Communication

- Identification, capture, exchange information in proper form and timeframe that allows people to perform their responsibilities
- Systems produce reports containing operational, financial and compliance related information
- Information must flow up, down, and across the organization
- Everyone must get a clear message from management that internal controls must be taken seriously. Everyone must understand their role.

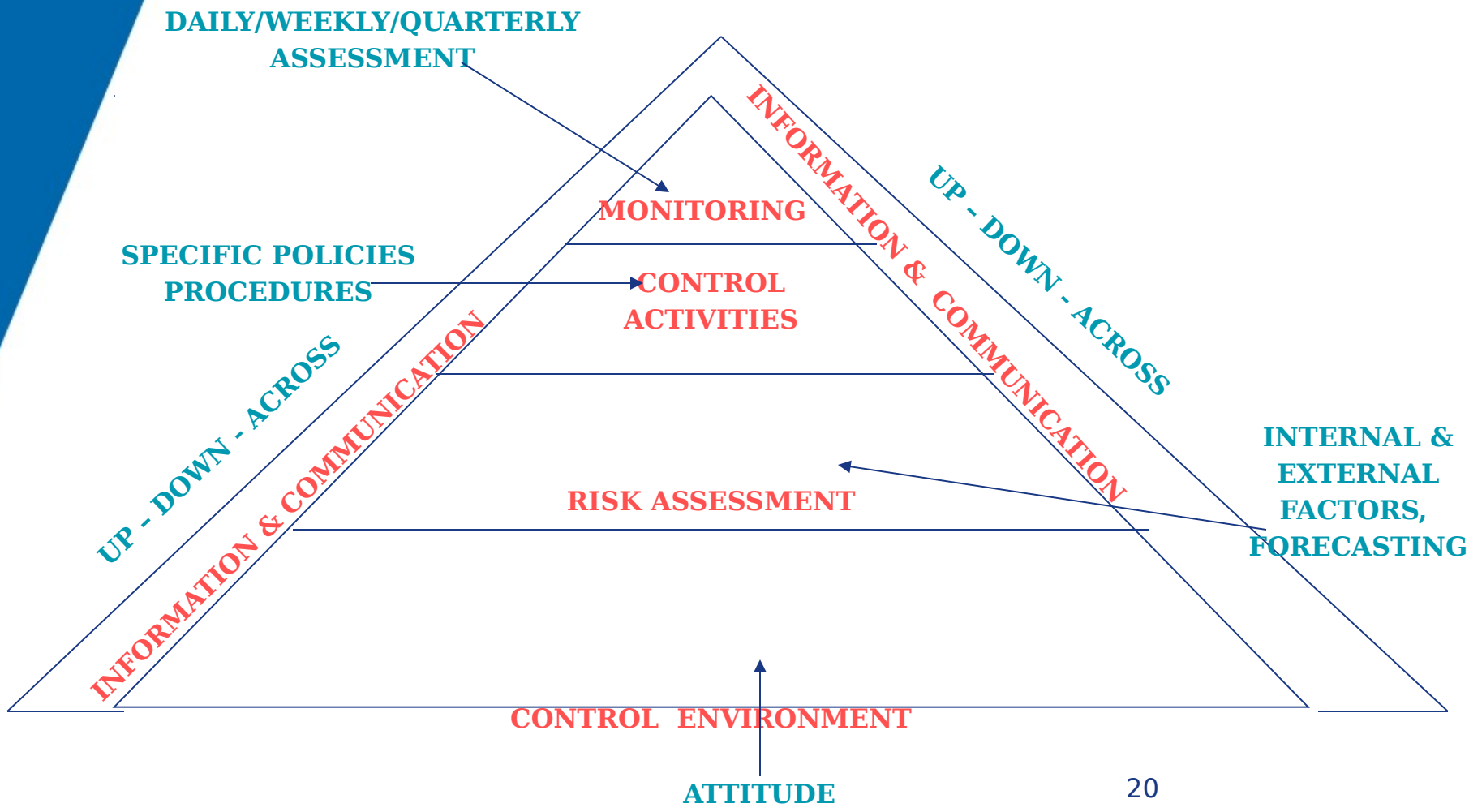
How = Staff meeting/staff notes/Management By Walking Around

Monitoring

- Quality of the internal control system over time
- Frequency depends on assessment of risk and effectiveness of monitoring procedures

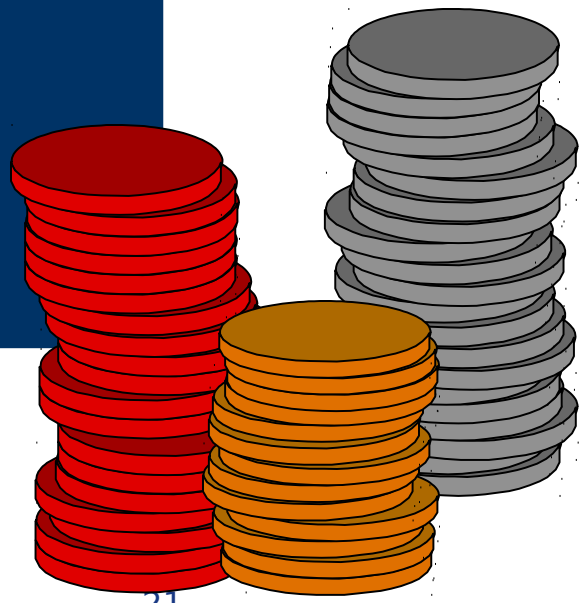
How = Management By Walking Around, Milestones, Briefings

Internal Control Standards Pyramid

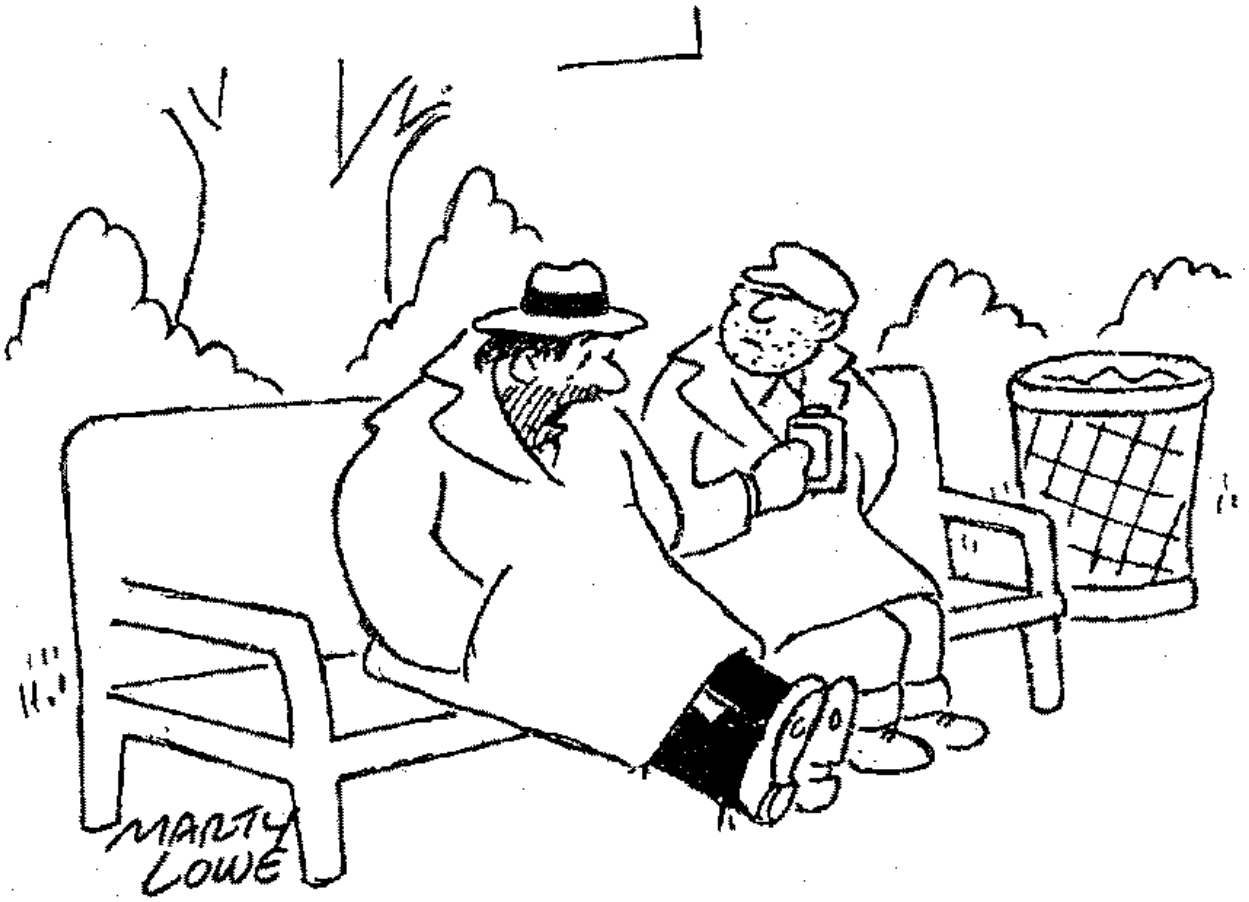


Overriding Concern with Internal Controls

- Must be cost effective and appropriate
- Cost and extent of controls in relationship to importance and risk of a program



AUDITOR'S ROLE



“Then I said: ‘I’ve nothing to hide, send in all the auditors you want.’”

Governing Criteria

- DODD 5010.38, Management Control Program
- DODI 5010.40, Management Control Program Procedures
- SECNAVINST 5200.35E, DON Managers' Internal Control Program
- OPNAVINST 5200.25C, CNO Management Control Program
- MCO 5200.24C, Marine Corps Internal Management Control Program

Assessing Internal Controls

- Continuous Process Using
  - Personal knowledge of programs
  - Internal management reviews
  - NAVAUDSVC, DoDIG, and GAO audits
  - Government Performance & Results Act (GPRA) results
  - Congressional hearing and reports

What We Look For In Our Audits

- DON command/activities
  - Requirement #1 – *Establish a MIC Program* to meet the goals of operational integrity and compliance with laws and regulations
  - Requirement #2 – *Assign responsibilities* for MIC Program management and performance of Internal Control evaluation
  - Requirement #3 – *Establish and maintain* an inventory of assessable units
  - Requirement #4 – *Continuously monitor/improve* the effectiveness of Internal Controls associated with their programs

What We Look For In Our Audits

- DON command/activities (con't.)
  - Requirement #5 – *Establish* and maintain a process that identifies, reports, and corrects material weaknesses
  - Requirement #6 – *Ensure* that managers responsible for systems of control are identified and that performance appraisals incorporate their responsibilities
  - Requirement #7 – *Provide training* for subordinate commanders/managers concerning their MIC Program duties

Additional Role

- Increase Awareness of Internal Controls
  - Navy & Marine Corps Conferences and Workshops
  - PDI's: ASMC, AGA, FLETC
  - DoD Military Comptroller School

WHY ARE INTERNAL CONTROLS IMPORTANT?

Importance of IC: Better Business Practices & Achieving Savings

"We have an obligation to taxpayers to spend

their money wisely. Today we're not doing

that…I have never seen an organization…that

could, by better management, operate at least

five percent more efficiently…Five percent of

the DoD's budget is over $15

Importance of IC: Financial Audits

"DoD gets an A in terms of accomplishing its mission—fighting and winning armed conflicts, but they get a D on economy, efficiency, and accountability."

Source: Comptroller General, David Walker's testimony before House Gov't Reform Subcommittee on Government Efficiency,

Importance of IC: NAVAUDSVC Report on Missing Computers with Classified Data

"We have not established the location of over 2400 computers."

Source: Fleet message, 17 October 2002

Importance of IC: Purchase Card Program

"Intentional use of the purchase cards for other than official business is a very serious matter that directly affects public confidence in the Department."

Source: Former Defense Comptroller Dov Zakheim's

Internal Controls CAN

- Help an organization achieve performance targets
- Prevent loss of resources
- Ensure reliable financial and information reporting
- Ensure compliance with laws and instructions
- Avoid damage to reputation and erosion of public confidence
- Demonstrate and communicate accountability
- Aid in strategic planning, operational monitoring and performance improvement
- Establish first line of defense to prevent and detect fraud
- Help manage change

Internal Controls CANNOT

- Ensure an organization's success or survival
- Change an inherently poor manager into a good manager
- Provide absolute assurance as to achievement of objectives
- Avoid negative publicity

When Internal Controls Don't Work

Error

Unauthorized Use

Abuse

Fraud

Waste

Loss

Accidents

When Internal Controls Don't Work

Basic or root causes of problems can typically be traced to a lack of, or breakdown in, internal controls. Many times, existing controls simply need updating or policies and procedures added to strengthen overall control system.

Source: GAO-02-69G, Strategies to Manage Improper Payments

Focus on Risk, Internal Controls & Compliance

- Sarbanes-Oxley Act of 2002
- Internal Audit/Oversight Risk and Opportunity Assessment

Sarbanes-Oxley Act of 2002

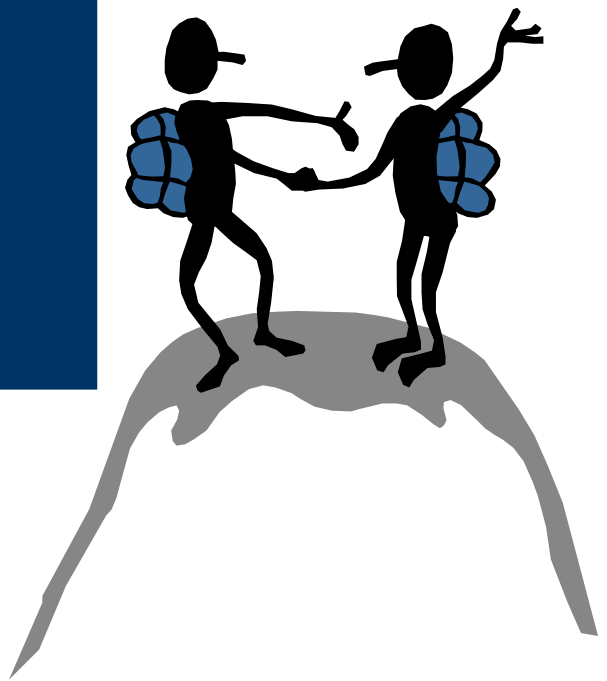
- Designed to protect investors
- Improving accuracy and reliability of corporate disclosures
- Sets forth series of regulations for
  - CEOs/CFOs
  - Internal/External Auditors
  - Audit Committees

Oversight Risk and Opportunity Assessment

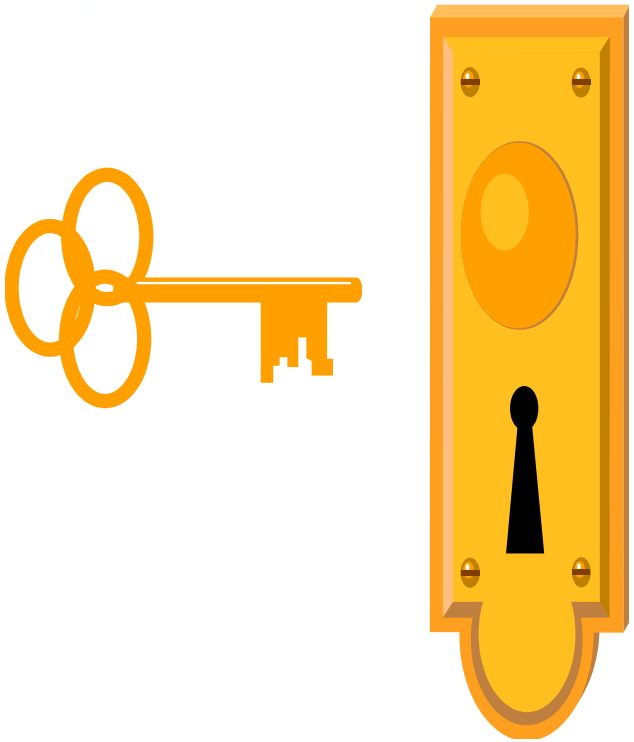
- Partnered with Public Accounting Firm
- Interviewed managers to identify areas of highest concern
- Identified 14 Issue Areas
  1. Information Technology Management & Deployment
  2. Financial Management
  3. Systems Acquisition & Management Logistics
  4. Logistics, Supply & Depot Maintenance Operations
  5. Anti-Terrorism/Force Protection
  6. Intelligence
  7. Fleet Support Operations
  8. Environmental Protection & Safety
  9. Health Care
  10. Manpower & Personnel
  11. Facilities & Real Property Management
  12. Education & Training
  13. Naval Governance
  14. Legislative & Public Affairs

Bottom Line

Internal Controls are the means to accomplish your mission within available resources and with surprises



Keys to Success



- Leadership Emphasis
- Education & Training
- Monitoring & Reporting
- Being Involved

2010 DON MATERIAL WEAKNESSES

2010 DON Material Weaknesses

- Governing Instructions
  - OMB Circular A-123
  - SECNAVINST 5200.35E
  - Managers' Internal Control Manual
    - Requires AUDGEN to identify internal control weaknesses
- Assessment Process
  - Review DON-related audit reports by GAO, DoDIG, and NAVAUDSVC
  - Brief OASN (FM&C) (FMO) quarterly
  - Brief Senior Officials In Charge
  - Brief ASN(FM&C) and Under Secretary of the Navy
- AUDGEN issues report summarizing results of assessment before the Secretary issues the Annual Statement of Assurance

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Weakness Classifications

- **Material Weakness:** A reportable condition or combination of reportable conditions, significant enough to report to the next higher level. The determination is a management judgment as to whether a weakness is material

- **Reportable Condition:** A control deficiency, or combination of deficiencies, that adversely affects the organization's ability to meet mission objectives but are not deemed by management as serious enough to be reported as a material weakness.

Suggested FY 2010 DON Material Weaknesses

- **Communications, Intelligence, and/or Security**
  - Communications Security (COMSEC) Equipment
- **Major Systems Acquisition**
  - Effective Use of Earned Value Management (EVM) Across Shipbuilding Programs
  - Attenuating Hazardous Noise in Acquisition and Weapons Systems Design
- **Other**
  - Safeguarding Personally Identifiable Information (PII)
  - DON's Transition of Personnel and Functions from Okinawa, Japan to Guam
  - Contract Administration

Communications Security Equipment

- **Condition:** COMSEC equipment is material used to protect U.S. Government transmissions, communications, and the processing of classified or sensitive unclassified information related to national security from unauthorized persons. Through a series of audits, NAVAUDSVC identified that improvements were needed in managing and accounting for COMSEC equipment. Equipment owners are required to maintain 100 percent accuracy of inventory records.

- **Risk:** Potential for missing or unaccounted for classified equipment that may result in significant compromise of national security.

- **Weakness:** DON has made significant improvements in COMSEC equipment management and accountability. However, DON does not have reasonable assurance that 100 percent accountability of COMSEC equipment exists.

Effective Use of Earned Value Management (EVM) Across Shipbuilding Programs

- **Condition:** EVM is one of the primary methods contractors and Government Program managers use to measure a contractor's cost, schedule, and technical progress on contracts for significant acquisition programs. Through a series of audits, NAVAUDSVC found that contractors' EVM systems were mostly noncompliant with DoD guidelines.

- **Risk:** DON does not have reasonable assurance in the accuracy and reliability of the data received from those contractors' systems to make programmatic decisions.

- **Weaknesses:** Government program managers and contractors are not using EVM systems to manage major weapons systems procurement actions. Additionally, DCMA, DCAA, and Supervisors of Shipbuilding are not effectively overseeing contractor implementation of EVM.

Attenuating Hazardous Noise in Acquisition and Weapons System Design

- **Condition:** NAVAUDSVC reported that the DON did not have sufficient processes to effectively mitigate hazardous noise risks posed by major weapon systems. Weapon systems program offices did not fully comply with requirements to reduce noise hazards during the acquisition process.

- **Risk:** High noise exposure may cause permanent hearing loss for service members.

- **Weakness:** There is no overall corporate approach to manage efforts to mitigate exposure to hazardous noise and the resulting noise-induced hearing loss.

Safeguarding Personally Identifiable Information (PII)

- **Condition:** NAVAUDSVC continues to report weaknesses in the proper collection, handling, and disposal of PII. Employee information containing PII (e.g., SSNs, drivers license numbers, birth dates, and places of birth) were accessible to anyone attempting to access websites, with a valid Common Access Card, at two audited commands. UNSECNAV issued a memo on 12 February 2010 to increase the awareness of this issue to DON employees and their dependents.

- **Risk:** Potential compromise of PII, identity theft, and damage to the reputation of the DON.

- **Weakness:** Safeguarding PII continues to be a material weakness until DON can provide reasonable assurance that proper internal controls are in place and functioning to sufficiently safeguard PII.

DON's Transition of Personnel and Functions from Okinawa, Japan to Guam

- **Condition:** The United States (US) Government and the Government of Japan agreed to relocate about 8,000 US Marine Corps personnel and their 9,000 dependents from Okinawa, Japan to Guam by 2014. The Joint Guam Program Office reported that costs and scheduled completion date have been grossly underestimated. In 2009, GAO reported that significant infrastructure problems (e.g., deteriorated roads, inadequate port throughput, limited construction capacity, and limited human and natural resources) could impede progress toward meeting that goal.

- **Risk:** The size of the project (potentially $20+ billion) represents a significant risk to the Department's financial outlook and reputation if the transition is not executed properly.

- **Weakness Areas:** Contracting, Schedule, Interagency coordination, Infrastructure management, Availability of qualified workforce

Contract Administration

- **Condition:** GAO, DoDIG, and NAVAUDSVC continue to report many findings addressing the lack of proper oversight over DON contracts. Also, the NAVAUDSVC found problems with contracting and disbursing operations at audited overseas locations.

- **Risk:** Hampers the DON's efforts to ensure there is a proper selection of contractors and that goods and services are received in accordance with the contracted terms. Also, the risk of significant potential fraud, waste, and abuse increases.

- **Weakness Areas:** Inexperienced personnel, Documentation, Delegation memos, Management oversight, Quality control, Deliverables and invoice certification, and Overseas contracting

Questions/Comments